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The Middle Eastern and African Arbitration Review 2021

A Global Arbitration Review Special Report

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The Covid-19 Factor: the Impact of Covid-19 on Damages Assessments

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In summary

The covid-19 pandemic has introduced new considerations into the assessment of damages, which may have material impacts. The impact of covid-19 extends to the preparation of cash flow forecasts, commonly accepted valuation methodologies and the appropriate date of assessment. Ultimately, covid-19 is likely to have a lasting impact on damages assessments. As covid-19 continues to disrupt businesses and economies globally, it is important to ensure that valuation conclusions are reasonable, and based on documentary evidence, or sensible assumptions.

Discussion points

- Preparation of projections and forecasts is more challenging
- Valuation approaches are subject to uncertainty
- Date of assessment may have a material impact

Introduction

On 9 January 2020, the World Health Organization announced a cluster of ‘pneumonia-like’ illnesses in Wuhan, China, which appeared to have been caused by a novel coronavirus.¹ By 3 February 2020 the US declared a public health emergency due to covid-19, and on 11 March 2020 the World Health Organization declared the spread of covid-19 to be a global pandemic.²

The effects of covid-19 have been rapid and uncompromising. Economic progress has been halted and restrictions on movement, activity and commerce have been introduced throughout societies across the world. From small business owners to the largest corporations in the world, the impact of covid-19 has affected every segment of the economy.

Covid-19 precipitated a dramatic decline in stock markets and economic activity. While many stock markets have subsequently rebounded (amid high volatility), unemployment rates have increased in all developed economies.³ The global economy entered recession in 2020 and is estimated to have contracted by 4.3 per cent.⁴

Governments have responded to covid-19 in divergent ways: some introduced lockdowns (to varying extents) to limit the spread of covid-19, while others did not. Regardless, most governments effected accommodative monetary policies to seek to constrain the economic damage inflicted by the pandemic.⁵

The implications of covid-19 on the assessment of damages in international arbitration disputes will be widespread and can already be observed. There will be disputes that arise directly as

a result of covid-19, and those where breaches are not caused directly by covid-19 but are nonetheless still impacted by the rapid economic changes caused by the pandemic. This is especially relevant to an assessment of damages. In this article, we focus on these changes, and consider:

- how covid-19 has impacted the ability of damages experts to effectively forecast the future performance of assets in disputes;
- the ramifications of covid-19 on commonly accepted valuation approaches; and
- how small changes in the date of assessment may cause material changes to an assessment of damages.

Challenges in preparing projections and forecasts

Where the actions or inactions of a party, allegedly in breach of contractual commitments, has caused another party to suffer economic damage, the quantification of losses is often based on a financial comparison between:

- the present value of the cash flows of the injured party in a hypothetical scenario in which the alleged contractual breach did not occur, referred to as the ‘but for scenario’; and
- the present value of the cash flows of the injured party based on its situation in fact, referred to as the ‘actual scenario’.

Often, projections of cash flows in the but for scenario are informed by business plans or forecasts prepared prior to the date of alleged wrongful conduct, or the historical financial performance of the entity or project in question.

In many cases, the ramifications of covid-19 could reduce the relevance of such information. It is possible, for example, that as a result of covid-19 (and regardless of the alleged contractual breach):

- customer demand for the products or services provided by the entity in question has changed;
- supply chains or production processes have been disrupted so as to render the provision of goods and services unfeasible across a particular period, at least at volumes considered to be ‘normal’ prior to covid-19; and
- the cost structure of businesses has changed, meaning that it is inappropriate to assume that historical unit costs or profit margins would remain the same post-covid-19.

Each of these factors could necessitate adjustments to pre-covid-19 data, and it will be necessary for experts to consider carefully the basis for such adjustments. In combination, it is possible that these and other factors may have fundamentally changed the economic viability of established business models and enterprises.

However, it is not only downside risks that business plans or forecasts prepared prior to covid-19, or an entity’s pre-covid-19 financial performance, may inadequately capture. Companies in

several industries, including technology and communications, have benefitted from sharp increases in demand.

Current business plans and projections are also likely to be more uncertain as a result of the pandemic. This is because entities' economic and operating environments are changing in unexpected ways, as governments and citizens adopt measures to address the health implications of covid-19. Uncertainty in the macro-economic environment is widely acknowledged. For example:⁶

- the International Monetary Fund cautions that there is a 'higher-than-usual degree of uncertainty' around its base-line forecasts;
- the Organisation for Economic Co-operation and Development reports that 'the economic outlook remains exceptionally uncertain, with the COVID-19 pandemic continuing to exert a substantial toll on economies and societies'; and
- the Bank of England states that 'the outlook for the economy remains unusually uncertain. It will depend on the evolution of the pandemic and measures taken to protect public health around the world'.

In many cases, the formation of reasonable assumptions will depend upon an assessment of the implications of the pandemic on the particular business in question, due to its diverse and wide-ranging effects. For example:

- in the case of a manufacturing company, it may be necessary to closely scrutinise its supply chain – the sequence of processes involved in production and distribution – to identify the impact of an alleged breach on the business in question;
- for a hotel, it will likely be necessary to understand the restrictions imposed by governments and other authorities on citizens' and visitors' rights to travel over the relevant period; and
- for a logistics company, acute shifts in demand due to the increased purchase of goods and services online rather than in-person could materially impact losses.

In other words, a 'one-size-fits-all' approach is unlikely to suffice, and valuers must be prepared to consider new factors that in the past would not have applied. It may also be appropriate to model scenarios based on different assumptions as one considers how the pandemic will continue to affect businesses as governments, economies and societies continue to grapple with its effects.

Valuation approaches subject to uncertainty

There are three commonly accepted valuation approaches used to by valuers in an assessment of damages:

- income-based approach under which the value of a business or asset is calculated by reference to explicit projections of its future cash flows, and the associated risks of earning them;
- market-based approach, under which the value of a business or asset is calculated by reference to the value of other comparable businesses or assets (in terms of growth, risk profile, geography or industry) or transactions in them; and
- asset-based approach, under which the value of a business is calculated by reference to the value of its assets. The asset-based approach often represents the minimum value of the company.

In the following paragraphs, we explore how each of these approaches may be impacted by covid-19.

Income-based approach

First, the income-based approach requires the valuer to prepare explicit forecasts of the future performance of the business, and the risk associated with these forecasts. We have explained above how the preparation of forecasts may be impacted by covid-19.

In addition, the level of risk associated with cash flow forecasts is also likely to have been impacted by covid-19. Under the income-based approach, valuers convert future cash flows into a present lump sum value. This is the 'value' of an asset.

The discount rate takes into consideration both the time value of money (that a dollar today is worth more than a dollar in one year), and the risks inherent in cash flow forecasts. It reflects the return required by providers of capital to a particular business or asset. This includes the return to shareholders (the cost of equity), the return to debt holders (the cost of debt), or both (the weighted average cost of capital).

Valuers often use the capital asset pricing model (CAPM) to model cost of equity. The CAPM formula is reproduced below:

$$\text{Required return} = \text{risk-free rate of return} + \text{the beta factor, or the exposure of the asset being valued to non-diversifiable risks} \times \text{equity risk premium}^7$$

Often, the risk-free rate of return is estimated with reference to the prevailing yield on US government bonds, or similar 'risk-free' assets. Yields on these assets have fallen significantly during the pandemic, both as a result of fiscal stimuli adopted by governments, and as investors seek to invest in 'risk-free' assets to avoid losses during periods of market volatility. Valuers may consider whether reliance upon very low risk-free rates is appropriate for forward-looking valuations, especially those which involve long-term cash flow forecasts.

Covid-19 has also caused increased volatility in stock markets. This impacts the estimation of both the beta factor and the equity risk premium, which are often based on market data. These inputs are typically estimated with reference to current data, as at the date of the assessment. However, the volatility introduced by covid-19 may limit the reliability of such data. At the same time, there is also a risk that pre-covid market data estimated may be stale, and inappropriate for damages assessments with valuation dates after the emergence of covid-19.

When considering the cost of debt, valuers often apply either the cost of debt for the business or asset in question, or for comparable companies. Valuers may need to consider when the debt was acquired, and whether the cost remains reflective of that which would apply at the date of valuation.

Market-based approach

The market-based approach requires a valuer to identify businesses or assets comparable to the one in question, and then infer financial ratios or 'multiples' for these comparable assets, either based on market data or transactions in these companies or assets. These multiples are applied to a relevant metric for the business or asset in question – often a measure of profitability – to estimate its value. As with the income-based approach, covid-19 may introduce novel challenges in applying the market-based approach to value assets.

For example, notwithstanding the covid-19 pandemic, the identification of appropriate comparable assets for use in a valuation can be challenging, particularly if the subject company operates in a niche industry or possesses unusual characteristics. This task may now be more difficult, as valuers may need to

consider whether previously comparable companies are likely to have responded to the pandemic similarly, or operate in countries where the effect of the pandemic was equivalent.

Further, in an analysis of multiples implied by transactions in comparable businesses or assets, it may be inappropriate to assume that pre-covid transactions can be used in valuations of assets after the pandemic arose. Alternatively, transactions that took place during the covid-19 pandemic could have occurred in situations where there was economic distress. Valuers must therefore take care to understand the transaction under review, and to consider whether it is appropriate to use as a reference point in the current circumstances. In many ways, these considerations reflect those that would typically concern valuers, prior to the pandemic. However, covid-19 has introduced a new dimension to factors under consideration.

Asset-based approach

In preparing an asset-based valuation, valuers often rely upon information contained in audited financial statements, or quarterly reporting. These documents state the value of a company's assets at a specific point in time.

However, companies may take different approaches to valuing assets. Some companies may revalue assets on a quarterly basis, some may revalue assets yearly. Valuers therefore need to consider how temporally relevant the information set out in these documents are to their damages assessments. Valuers should also consider the likelihood of functional or economic obsolescence of assets, due to reduced demand or economic constraints introduced by the pandemic.

Date of assessment

Valuers are typically asked to conduct a damages assessment at a particular point in time, the date of assessment. The appropriate date of assessment is a question of law. However, it can affect the quantum of damages suffered considerably, as often valuers should only consider information known or knowable at the date of assessment.

As the covid-19 pandemic has caused rapid changes in companies' abilities to operate, large changes in value have occurred over short-timescales. In some cases, valuers may therefore need to pay particular consideration to the facts and circumstances applicable to the business in question at the date of assessment.

Valuations prepared on a current basis may also change in unexpected ways, as the implications of the pandemic unfold. Valuers must be prepared to explain such changes, and why they are reasonable and appropriate in the circumstances.

Conclusion

In this article, we have identified that covid-19 may affect an assessment of damages in a number of different ways including:

- how forecasts are prepared. Covid-19 has introduced additional challenges in preparing cash flow forecasts and new factors that would not have applied in the past;
- the adoption of commonly accepted valuation methodologies. Covid-19 has an impact on each methodology. Forecasting the risks associated with future cash flows may become increasingly difficult, and covid-19 data may cease to be relevant post-covid-19; and
- the appropriate date of assessment is likely to become an issue of focus. Owing to covid-19, changes in the date of assessment may lead to material changes in the quantum of damages.

The common theme across these factors is that covid-19 has introduced new considerations into the assessment of damages, which may have material impacts. Owing to the uncertain nature of covid-19, there are often multiple approaches valuers can adopt to include the impact of the pandemic in their assessments. To counteract this, scenario analysis will become increasingly important, which may aid tribunals in their role as ultimate arbiters of fact in international arbitration disputes.

Ultimately, covid-19 is likely to have a lasting impact on damages assessments. As covid-19 continues to disrupt businesses and economies globally, it is important to ensure that valuation conclusions are reasonable, and based on documentary evidence, where available, and sensible assumptions where this evidence is not available.

The views expressed in this article are those of the authors and not necessarily the views of FTI Consulting Inc, its management, its subsidiaries, its affiliates or its other professionals.

Notes

- 1 A Timeline of COVID-19 Developments in 2020, *The American Journal of Managed Care*, 2 January 2021.
- 2 A Timeline of COVID-19 Developments in 2020, *The American Journal of Managed Care*, 2 January 2021.
- 3 Global economic prospects, World Bank, January 2021.
- 4 Global economic prospects, World Bank, January 2021.
- 5 Policy responses to COVID-19, International Monetary Fund.
- 6 World Economic Outlook Update, IMF; Economic Outlook – Interim Report, OECD, September 2020; Monetary Policy Report, September 2020, Bank of England.
- 7 The equity risk premium represents the premium required by the investor to invest in the equity market over the risk-free rate.



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